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No. 73-469

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

HARRIET SIGNER, *Petitioner*

v.

TRUSTEES OF THE PROPERTY OF PENN CENTRAL TRANSPORTATION COMPANY, DEBTOR, *Respondents*

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

George P. Baker, Richard C. Bond and Jervis Langdon, Jr., Trustees of the Property of Penn Central Transportation Company, Debtor (Respondents), submit this brief in opposition to the Petition of Harriet Signer (Petitioner) for a Writ of Certiorari to review a judgment of the Circuit Court of Appeals for the Third Circuit. That judgment affirmed an order of the District Court for the Eastern District of Pennsylvania in the proceedings for

reorganization of Penn Central Transportation Company, Debtor (Penn Central), denying Petitioner's application for sequestration of the income from certain nonoperating properties of Penn Central mortgaged to secure bonds held by petitioner.

All the contentions raised by the Petition for Certiorari have been fully considered by the Courts below and disposed of adversely to Petitioner in accordance with controlling principles established by this Court and the Circuit Courts of Appeals. The Petition should therefore be denied.

OPINIONS BELOW

The opinion of the District Court is reported at 354 F. Supp. 757 and is printed as Appendix A to the Petition. The Judgment Order of the Court of Appeals affirming the District Court is printed as Appendix B to the Petition. The opinion of the District Court refers to its Opinion and Order No. 974, reported at 354 F. Supp. 717, for a statement of the grounds for its action. Relevant excerpts from this opinion are printed in the appendix to this brief. (RA 1-9). Similarly, the Judgment Order of the Court of Appeals refers to its opinion in *In the Matter of Penn Central Transportation Company, Morgan Guaranty Trust Company of New York, et al., Appellants,* to explain the grounds for its judgment. The relevant excerpt from that opinion also appears in the appendix to this brief (RA 10-11).

Page references preceded by the letter "A" herein are to the Appendix to the Petition and page references preceded by the letters "RA" are to the appendix to this brief.

STATEMENT OF CASE

The facts relevant to the issues sought to be raised by the petition can be simply stated. Petitioner owns $40,000 in principal amount, and purports to speak for seven additional persons holding an additional $700,000 in principal amount, out of a total of more than $250,000,000 of bonds outstanding under the Refunding and Improvement Mortgage dated October 1, 1913 (the R & I Mortgage) of New York Central and Hudson River Railroad Company (New York Central), a predecessor of Penn Central (A 4). The R & I Mortgage and two prior mortgages of the New York Central (collectively the Hudson River Mortgages) are liens on valuable non-railroad real estate of Penn Central located in New York City (the Park Avenue Properties) and also on large portions of the Penn Central railroad system (RA 3). No interest has been paid on bonds outstanding under the Hudson River Mortgages since the filing of Penn Central's petition for reorganization in June 1970. The Trustees have been collecting income from Park Avenue Properties and applying it, along with other available funds, to expenses incurred by the Trustees in operating the Penn Central railroad system. It is estimated that losses on railroad lines subject to the Hudson River Mortgages exceed the cash flow from the Park Avenue Properties (RA 3, 6).

In October 1971 Petitioner filed in the reorganization proceedings a petition seeking sequestration of the income of the Park Avenue Properties and its application to payment of state and local taxes on the Properties and interest on the R & I Bonds. Before any hearing was held on this petition the trustees

under the three Hudson River Mortgages filed a joint petition seeking the same relief. The Penn Central Trustees answered and a full evidentiary hearing was held. Notwithstanding the assertion in the Petition for Certiorari that "appellant here was not a party to that proceeding nor received any notice relating thereto," Mrs. Signer appeared through counsel at the hearing and was granted leave to and did file a brief in support of sequestration (A 1-2, RA 6-7). A further hearing was held solely on the Signer petition prior to its denial by Order No. 988 of the District Court.

The District Court concluded that "sequestration of the income from the Park Avenue Properties would substantially impair the ability of the Debtor to reorganize and to provide continued rail service" (RA 8-9), and denied the petitions for sequestration (A 4-5, RA 9).

REASONS FOR DENIAL OF THE WRIT

The petitioner's contention, stripped of procedural details, is simply that permitting a debtor in reorganization to use the income of mortgaged properties to support operations of the debtor pending reorganization amounts to an unconstitutional taking of property without due process of law.

The law is clear to the contrary. In *Continental Illinois Nat. Bank & Trust Co.* v. *Chicago, Rock Island & P. Ry.*, 294 U.S. 648 (1935), this Court established the principle that in a reorganization the remedies of a secured creditor may be deferred to afford a reasonable opportunity to work out a plan of reorganization. The Court of Appeals for the

Third Circuit has twice applied that principle to petitions for sequestration of income of mortgaged or pledged property of a debtor in reorganization. In *Central Hanover B. & T. Co.* v. *Philadelphia & Reading Coal & Iron Co.*, 99 F.2d 642 (3rd Cir. 1938), involving income from operating properties, the Court said (99 F.2d at 645):

> ". . . it was entirely proper for the court below to refuse to order the physical sequestration and impounding by the Debtor for the benefit of the bondholders of the income of the mortgaged property. It is clear that the court in so doing did not deprive the appellant or the bondholders it represents of their property without due process of law in violation of the fifth amendment. Continental Illinois Nat. Bank. & Trust Co. v. Chicago, Rock Island & P. Ry. Co., *supra;* Wright v. Vinton Branch, 300 U.S. 440, 57 S. Ct. 556, 81 L.Ed. 736, 112 A.L.R. 1455."

In re Philadelphia & Reading Coal & Iron Co., 117 F.2d 976 (3rd Cir. 1941) involved sequestration of dividends on shares of pledged stock and interest on pledged bonds. The Court said (117 F.2d at 979):

> "In order to effectuate the policies of the Bankruptcy Act a debtor undergoing reorganization should be permitted to receive and retain during the reorganization proceeding the income from its mortgaged and pledged property which under the terms of the mortgage or pledge it had been permitted to enjoy prior thereto, *unless the court is satisfied that the retaking* of the income or part of it by the mortgagee or pledgee *will not prejudice the operation of the business of the debtor* during the reorganization proceeding." (Emphasis added.)

In the present case the District Court affirmatively found that the income sought to be sequestered was needed to assure continued rail operation pending reorganization (RA 6, 8-9).

See also *R.F.C.* v. *Kaplan,* 185 F.2d 791 (1st Cir. 1951); 6A Collier on Bankruptcy, § 14.03[1] (14th ed).

No case cited by Petitioner even remotely supports her contentions. Indicative of the absence of any real merit to her legal position is the fact that, faced with the findings made by the District Court, none of the Hudson River Mortgage trustees appealed the order denying their sequestration petition.

CONCLUSION

The petition for certiorari raises no issues meriting review by this Court and should be denied.

Respectfully submitted,

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Dated: September 28, 1973

APPENDIX

UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In the Matter of

PENN CENTRAL TRANSPORTATION COMPANY, Debtor

In Proceedings for the Reorganization of a Railroad

Pla. No. 70,347

APPENDIX

OPINION AND ORDER NO. 974

[Re: Sale of Park Avenue Properties]

PUTNAM, J. October 20, 1972

* * * * * * * * * * *

INTRODUCTION

The Trustees seek authorization to sell certain major real estate holdings of the Debtor located in the Park Avenue area of the City of New York, for prices totalling $59,540,000. Conditional or absolute objections to some or all of the proposed sales have been interposed by several interested parties, on a variety of legal and factual grounds.

The following issues, directly or indirectly related to the proposed sales, are presented for decision:

* * * * * * * * * * *

[illegible] case the District Court affirmatively [illegible] the income sought to be sequestered was [illegible] to assure continued rail operation pending reorganization (RA 6, 8-9).

See also *N.Y.C. v. Kaplan*, 185 F.2d 791 (1st Cir. 1951); 6A Collier on Bankruptcy, §14.03[1] (14th ed.).

No case cited by Petitioner even remotely supports her contentions. Indicative of the absence of any real merit to her legal position is the fact that, faced with the findings made by the District Court, none of the Hudson River Mortgage trustees appealed the order denying their sequestration petition.

APPENDIX

CONCLUSION

The petition for certiorari raises no issues meriting review by this Court, and should be denied.

Respectfully submitted,

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INTRODUCTION

The Trustees seek authorization to sell certain major real estate holdings of the Debtor located in the Park Avenue area of the City of New York, for prices totalling $59,549,000. Conditional or absolute objections to some or all of the proposed sales have been interposed by several interested parties, on a variety of legal and factual grounds.

The following issues, directly or indirectly related to the proposed sales, are presented for decision:

• • • • • • • • • • •

4. Are the trustees entitled to use the income from the properties for operating expenses, or must the income be sequestered, either

(a) by reason of the rights of the New Haven trustee? or

(b) by reason of the rights of certain indenture trustees?

• • • • • • • • • • •

FINDINGS OF FACT

1. The Debtor's estate includes various real estate holdings in the Borough of Manhattan, in the City of New York, commonly known as the Park Avenue Properties (the "Properties").

2. In general, the Debtor has constructed rail facilities below the street level of these properties. The use of the subsurface rights for the Debtor's rail operations has not detrimentally affected the value or usefulness of the surface and air rights for commercial development.

3. The Properties have been developed during this century for office or hotel use.

4. The Debtor's interests in the Properties are of two kinds: fee interests originally acquired by the Debtor's corporate predecessors; and leasehold rights under a 401-year lease executed in 1873 by the New York and Harlem Railroad Company (the "Harlem") in favor of the New York Central and Hudson River Railroad Company. Certain of the Properties were developed on parcels in which the Debtor has combined fee and leasehold rights.

• • • • • • • • • • •

8. The annual cash flow to the Debtor from the Properties is subject to fluctuations occasioned by the participation provisions or similar arrangements found in many of the ground leases. The actual rental payment received by the Debtor from the Properties exclusive of tax pay-

ments made directly to the City of New York under the respective leases or pursuant to orders of this Court is approximately $20 million to $22 million per annum. Capital improvements to the hotels cost the Debtor between $2 million and $3.5 million per annum, and the Debtor's annual tax liabilities on the Properties, over and above taxes paid directly by the lessees total approximately $6.5 million per annum.

9. Assuming continued deferral of taxes, the annual cash flow from the Properties is in the area of $16 to $17 million. If taxes were to be paid on a current basis, the cash flow would be about $10 to $11 million per year.

10. The Trustees' fee interests and leasehold rights in the Properties are subject to three mortgages known as the Hudson River Mortgages:

a. The New York Central & Hudson River Railroad Company 3½% mortgage dated June 1, 1897;

b. The New York Central and Hudson River Railroad Company Consolidated Mortgage dated June 20, 1913;

c. The New York Central and Hudson River Railroad Company Refunding and Improvement Mortgage dated October 1, 1913 ("R & I Mortgage").

11. Security for the Hudson River Mortgages consists in part of approximately 2,000 route miles and 4,000 track miles of the Central's operating property east of Buffalo. The R & I Mortgage is also secured by a lien of various rankings on an additional 1,700 route miles and 3,500 track miles as well as a lien on the Debtor's leasehold rights under six lease agreements covering 2,300 route miles and 4,200 track miles.

12. Definitive segregation studies are not available to determine the losses incurred by various segments of the Debtor's system. It is estimated that the losses on the line constituting the security for the Hudson River Mortgages

is equal to or greater than the annual cash flow from Park Avenue Properties.

* * * * * * * * * *

B. Affirmance Conditions

* * * * * * * * * *

2. Payment of Dividends on the Debtor's Harlem Stock, Pledged with the Trustee of the R&I Mortgage

The R&I Mortgage constitutes a lien on most of the real estate formerly owned by the New York Central, now owned by the Debtor. In addition, the R&I indenture trustee holds the Debtor's Harlem stock as collateral security (Finding No. 78). Under the terms of the R&I indenture, in the event of default the indenture trustee is entitled to receive dividends on the pledged stock and apply them to the mortgage debt. Under the Third Supplemental Contract to the Harlem lease, the Debtor is excused from paying that portion of the rental representing $5 per share per year on stock owned by the Debtor, only if the R&I indenture trustee is not entitled to receive the dividends under the mortgage. The annual dividends on the pledged stock would amount to about $950,000.

Morgan Guaranty, as indenture trustee of the R&I mortgage, contends that, as a condition of affirmance of the Harlem lease, the Trustees must either pay all arrearages and continue to pay currently the dividends on the pledged stock, or acknowledge that Morgan's claim to these dividends ranks as an administration claim.

It should be noted at the outset that the resolution of this phase of the controversy will not affect the lessor. Under any view of the matter, the ultimate issue is whether dividends on pledged stock should be paid over to the pledgee, or retained by the pledgor to meet operating expenses. Thus, even if it were to be held that, for purposes of formal compliance with the rental requirements of the lease, the Trustees should pay rental calculated on the ba-

sis of paying dividends on all of the Harlem stock, the issue would still remain whether the Harlem should pay these dividends to the Trustees/pledgors, or to Morgan Guaranty/pledgee. Whatever rights Morgan has to receive the dividends arise under the R&I indenture and the pledge agreement; its claims are against the Debtor, not the Harlem.

It is clear that a reorganization court may properly order that dividends on pledged securities be paid to the Debtor's estate and expended for operating purposes. *R.F.C.* v. *Kaplan,* 185 F.2d 791 (1st Cir. 1951); 6A Collier on Bankruptcy, § 14.03[1] (14th ed.) and cases cited therein. Morgan's argument is virtually identical to the argument rejected by the Third Circuit in *In re Philadelphia & Reading Coal & Iron Co.,* 117 F.2d 976 (3d 1941). In that case, Judge Maris concluded that there is no justification for treating income from pledged stock any differently than income from real property subject to a mortgage lien, *Central Hanover Bank & Trust Co.* v. *Philadelphia & Reading Coal & Iron Co.,* 99 F. 2d 642 (3d Cir. 1938); and that it was appropriate for a reorganization court to suspend a pledgee's contractual right to receive the income from pledged securities, and to permit the trustees to use the income to support the current operations of the debtor, if the income was needed for that purpose. *See also In re Philadelphia Coal & Iron Co.,* 141 F.2d 954 (3d Cir. 1944); *In re Industrial Office Building Corp.,* 171 F.2d 890 (3d Cir. 1949).

That the Trustees need this income to assure continued rail operations pending reorganization cannot be doubted. While the results of Debtor's current operations continue to improve, the Trustees have not yet been able to resume payment of current real estate taxes. Because of seasonal fluctuations, cash flow projections remain marginal. The cash drain occasioned by tropical storm Agnes has been severe. In application of the principles set forth in the

cases cited above, I have concluded that the Trustees should retain the benefit of the dividends on the pledged Harlem stock.

I express no view as to whether Morgan Guaranty is entitled to administration claim status in connection with these deferred dividend payments. I believe all such matters should be resolved in connection with the proof of claims program and the plan of reorganization.

* * * * * * * * * *

D. Other Petitions to Sequester Income

The Hudson River Mortgage trustees represent bondholders under three of the Central's major bond issues (Finding No. 9). These mortgages are secured by substantial parts of the rail properties east of Buffalo, and by the Debtor's fee and leasehold interests in the Park Avenue Properties (Findings 5 and 6). Interest on the bonds has not been paid since reorganization, and the Debtor's portion of real estate taxes has not been paid. Under Order No. 1, the mortgage trustees are enjoined from exercising their remedies under the mortgage by reason of these defaults.

The Park Avenue Properties generate substantial amounts of income. Although the record is, unfortunately, not clear as to the precise amount of net income derived therefrom, the amount is at least $10 million annually. The Trustees have been using this income for general operating expenses. The Hudson Mortgage trustees (and, in a separate petition, an individual bondholder, Harriet Signer) have petitioned for sequestration of the income from the properties. The petitioners request that this income be escrowed for the benefit of the Hudson River bondholders (subject to certain claims of the Harlem bondholders) and that there be an accounting of all post-reorganization income, and a declaration of administration claim status for the income thus far expended by the Trustees.

The basic issue is this: Does a § 77 reorganization court have constitutional and statutory power to permit the Trustees of the Debtor railroad to use for operational expenses during the period before a plan of reorganization is filed, income generated by real property subject to mortgage liens; and, if so, should such permission be extended under the present circumstances?

In many respects, the same considerations are applicable here as were discussed in Part I (B)(2) of this opinion, in connection with the treatment of dividends on pledged stock.

While a reorganization court undoubtedly has the power to require that income from mortgaged property be paid to the mortgage trustees, *Missouri Pacific Ry. Co. 5¼% Secured Serial Bondholders Committee* v. *Thompson,* 149 F.2d 799 (8th Cir. 1952), or to restrict the use of rental income by the Trustees of the Debtor, *In re Franklin Garden Apartments,* 124 F.2d 451 (2d Cir. 1941), it is at least equally clear that a reorganization court does have the power to permit the Debtor's Trustees to use this income for operating expenses. *In re Philadelphia & Reading Coal & Iron Co.,* 117 F.2d 976 (3d Cir. 1941); *see also Central Hanover Bank & Trust Co.,* 99 F.2d 642 (3d Cir. 1938; 6A Collier on Bankruptcy, § 14.03 [1] (14th ed).

The Signer brief argues that the Third Circuit decisions just cited are an aberration and should be disregarded in this proceeding in view of the decision of the Supreme Court in *Louisville Joint Stock Land Bank* v. *Radford,* 295 U.S. 555 (1935). The *Radford* case held that the original Frazier-Lemke Act (granting farmers certain relief from foreclosures) was unconstitutional. However, a second Frazier-Lemke Act was passed in 1935, and its constitutionality was upheld in *Wright* v. *Vinton Branch,* 300 U.S. 440 (1937) (not cited or referred to in the Signer brief). The *Philadelphia & Reading Coal & Iron Co.* cases were decided by the Third Circuit Court shortly after the *Rad-*

ford decision by the Supreme Court. There is nothing in *Radford* which undercuts the holdings of the Third Circuit on the propriety of permitting a debtor in reorganization to use rental income for operational expenses. Needless to say, the same is true of *Wright* v. *Vinton Branch.*

The Hudson River Mortgage trustees argue that denial of their present petition would violate their vested property interests, by reason of the fact that unpaid real estate taxes are accruing on the properties, and impair their security. The short answer to this argument is that the *claim* of the bondholders is not diminished by the prior tax liens on the property, nor would the value of their security for purposes of the plan be affected by the existence of the tax liens. If the mortgage trustees' theory were adopted, it would follow that § 77 relief would be available only to a railroad whose financial difficulties were confined to an overburdened capital structure. In a case such as the present one, where operations do not generate sufficent cash to cover all real estate taxes, temporary deferral of taxes is a necessity. Order No. 70 herein, authorizing deferral of taxes, has been upheld on appeal (452 F.2d 1107 (3d Cir. 1971), *cert. denied,* 406 U.S. 944 (1972). The essence of these decisions is that, consistent with the provisions of §77, it is appropriate to provide the Trustees some "breathing room" so that, in their efforts to rehabilitate the Debtor, they can, for a reasonable period, use cash which would otherwise have gone to pay taxes, to meet current operating expenses. If the mortgage trustees' argument were to be accepted, the entry of a tax deferral order would serve merely to create grounds for depriving the Trustees of income, and would be self-defeating. In my judgment, there is no basis for imposing such a limitation on the statutory scheme of § 77.

Thus, the real issue is whether sequestration of the income from the Park Avenue Properties would substantially impair the ability of the Debtor to reorganize and to pro-

vide continued rail service. For the reasons summarized in Part I(B)(2) above, I have concluded that it would, and that under the circumstances the Trustees should continue to have the use of this income.

Needless to say, just as in the case of the tax deferral orders, this determination is subject to reconsideration at any time, as circumstances develop.

A final contention is that Order No. 15 herein constitutes the "law of the case," and that denial of the present petitions would be inconsistent with that order. This contention lacks merit. Order No. 15 was entered shortly after reorganization, before the Trustees were appointed; it was entered by consent; it does not purport to be a final determination of any issue, but is merely a "status quo" order designed to prevent irreparable injury while underlying issues are negotiated or litigated. It is expressly subject to being reopened at any time upon the application of any party adversely affected thereby.

The present sequestration petitions will be denied.

* * * * * * * * * *

Order No. 979

And Now, this 20th day of October, 1972, for the reasons stated in Part II(D) of Opinion and Order No. 974, it is Ordered that the Petition of the Hudson River Indenture Trustees for sequestration of income from the Park Avenue Properties (Document No. 2672) is Denied.

/s/ John P. Fullam

Excerpt from Opinion of the Third Circuit June 14, 1973

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Nos. 72-2116, 72-2117, 72-2118, 72-2119, 72-2120, 72-2121, 72-2122, 72-2123, 72-2124, 72-2125, 72-2126.

In the Matter of:

PENN CENTRAL TRANSPORTATION COMPANY, *Debtor*

MORGAN GUARANTY TRUST COMPANY OF NEW YORK, As Trustee Under Mortgages of New York and Harlem Railroad Company and Under Certain Mortgages of New York Central and Hudson River Railroad Company; MANUFACTURERS HANOVER TRUST COMPANY and BANKERS TRUST COMPANY, Each as Trustee Under a Mortgage of New York Central and Hudson River Railroad Company; RICHARD JOYCE SMITH, As Trustee of the Property of the New York, New Haven & Hartford Railroad Company, Debtor; THE FIDELITY BANK; and PENN CENTRAL COMPANY, *Appellants.*

* * * * * * * * * * *

The Morgan Guaranty, in its capacity as Trustee under the R&I mortgage of the New York Central, contends that it is entitled to rental payments or dividends on the stock of Harlem. Under the R&I mortgage, the shares of the Harlem owned by Penn Central are pledged as security for the bonds. Morgan Guaranty claims that since the R&I bonds are in default, it has foreclosed on the collateral and now is in possession of the Harlem shares. As stated earlier, Penn Central holds title to about 95% of the Harlem shares, the remaining 5% being publicly held. The $5 dividend, or rental payment, due on the 5% of the shares not held by the Penn Central has been paid throughout the reorganization, although no payment has been made on the 95%. Morgan Guaranty asserts that because these shares have passed from the Penn Central to the mortgage trustee as a result of the default, it is entitled either to receive

the dividends accrued and those that come due or to have these claims ranked as an administrative claim.

The district court, relying on this Court's opinion in *In re Philadelphia & Reading Coal & Iron Co.*,[54] held that the income produced by the pledged shares was available to the Trustees of the Penn Central and need not be paid to the pledgee. Having thus denied the claim for immediate payment, the district court deferred a determination of the status to be accorded Morgan Guaranty's claim until the formulation of the reorganization plan. We affirm these holdings of the district court.

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[54] 117 F.2d 976 (3d Cir. 1941).